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SUBJECT: CEFTA - SERBIA SEEKS COMPROMISE ON CIGARETTES;
U.S. BUSINESS INTERESTS INVOLVED

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SUMMARY

11. (SBU) In order to break an impasse on the initialing of the Central European Free Trade Agreement (CEFTA), the Government of Serbia (GOS) has offered a concession to Croatia on cigarette duties. In a November 30 letter, Serbia's chief negotiator offered to lower the overall level of protection for imports, a move that would be consistent with WTO standards, according to local experts. Serbian officials believe that Croatia's position is overly inflexible given market realities, but hope that a resolution can be reached that would allow initialing of the CEFTA agreement by December 19. Philip Morris, which owns the largest cigarette factory in Serbia, is pressuring the Serbian Government to honor the commitments it made to support domestic manufacturers until the end of 2009. END SUMMARY.

COMMITMENTS TO FOREIGN INVESTORS

12. (SBU) The Government of Serbia announced on November 9 that it would not initial CEFTA, but, clearly feeling the pressure, it has continued to seek a way out of the stalemate. Serbia's reluctance stems from Croatia's demand that Serbia reduce its excise tax on imported cigarettes to the level of excise on domestic cigarettes, without increasing cigarette import duties. However, the GOS faces strong pressure from foreign cigarette producers because of prior commitments made to Philip Morris, British American Tobacco and Japan Tobacco International. Philip Morris purchased the largest cigarette factory in Serbia for hundreds of millions of dollars in 2003.

15. (U) The current protection for the cigarette industry was a commitment to foreign investors who took on heavy obligations regarding investment, employment, and use of local tobacco in their privatization agreements. The excise tax favors domestic manufacturers over foreign in a 1:10 ratio with a 30 percent ad valorem tax. In January 2007, the ratio goes to 2:10 with a 40 percent ad valorem tax, before reaching a 5:5 ratio with a 50 percent ad valorem tax in 2010. However, Serbia came under heavy pressure from all quarters to abandon this system, which is clearly discriminatory.

16. (SBU) On November 6, Serbia proposed an alternative that is consistent with World Trade Organization (WTO) and

European Union standards. It would equalize excise taxes while increasing Serbia's relatively low import duties on cigarettes, with no net increase in protection. It also provided a phased structure that would put all CEFTA cigarette manufacturers on equal footing by 2010. The EU, in a November 21 letter from Commissioners Rehn and Mandelson, affirmed the WTO-consistent status of the Serb offer, while Stability Pact trade expert Mary O'Mahony confirmed that the Serbian offer provides an equivalent level of protection.

17. (SBU) Croatia, however, rejected Serbia's proposal on the principle that CEFTA negotiations could be concluded only on the basis of a standstill in protection levels -- that is that tariff levels in the previous bilateral agreements, in effect, constitute a ceiling for the new CEFTA agreement. Such a position poses a dilemma for Serbia: if it abandons the discriminatory excise, while keeping its tariff level low, it would have no other means to provide the promised protection to domestic producers.

18. (SBU) Philip Morris, in particular, has been outspoken in demanding that the GOS not retreat from the overall protection guaranteed in privatization agreements. (Philip Morris has invested about USD 560 million in its Nis cigarette operation and is the market leader in Serbia.) However, Eugenio Sidoli, general director of Philip Morris, told econoff that the industry, which is sensitive to Serbia's desire to initial the CEFTA pact, had agreed to the lower protection level in Serbia's November 30 offer to Croatia, which would reduce the current level of protection from EURO 8.9 per 1,000 cigarettes to 8.4 in April, 2007.

19. (SBU) Croatia's insistence on a standstill has further complicated prospects for a deal, O'Mahony pointed out, because such a stance also undercut a tentative agreement between Bosnia and Croatia on agricultural tariffs. Croatia had agreed on October 20 to higher tariffs for

agricultural imports in Bosnia and Herzegovina (BIH), but the Croats reportedly did an about-face on November 7 and have asserted the standstill principle in further discussions both with Serbia and Bosnia. "They were willing to change it for Bosnia, till Serbia requested the same treatment," O'Mahony said.

110. (SBU) O'Mahony said that Stability Pact officials are concerned that, even if the Serbs and Croats find some way to work around the cigarette impasse, Bosnia could still be left out in the cold over agricultural tariffs. Rehn and Mandelson, in their November 21 letter to Croatian Prime Minister Sanader, zeroed in on this issue: "We were particularly disappointed to learn that, after having reached an agreement in principle with the Bosnian side at the last negotiating round; the Croatian negotiators were, in an apparent change of position, unable to confirm a possible deal on agricultural concessions."

111. (SBU) Many in Serbia's tobacco industry perceive Croatia's position as unreasonable. Eugenio Sidoli, general director of Philip Morris, told econoffs that Croatia's monopoly producer controls 6 percent of Serbia's market, which is three times larger than Croatia's. However, Serbian producers have zero market share in Croatia because of a discriminatory tobacco classification system that categorizes all imported cigarettes, regardless of brand, in the category with the highest excise tax. He said that during accession negotiations, the EU had asked Croatia to change this system, but the transition period could last years.

112. (SBU) O'Mahony, who termed the latest Serb offer "quite attractive," is at a loss to explain the Croatian stance. While the Sanader government certainly faces pressure from its government-owned tobacco producer, other Croatian producers should be in a position to exploit a more liberal trade regime, she explained. (Croatia exported USD 9.3 million in cigarettes to Serbia in 2005,

roughly 6 percent of the total market, while total exports were only USD 17.3 million, far less than 1 percent of Serbia's total imports.) O'Mahony said that, given the underlying economics, Croatia's position simply doesn't make sense.

¶13. (SBU) COMMENT. Serbia will continue to seek ways out of this impasse; it clearly wants to sign the CEFTA deal in Bucharest on December 19. But cigarette producers here have told the GOS bluntly that they want compensation if the protection levels are substantially reduced before the promised phaseout at the end of 2009. There is a strong feeling in Belgrade that Zagreb is being unreasonable and that its position is, in essence, that what's ours is ours, while yours is negotiable.

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